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IN THE

Supreme Court of the United States

OCTOBER TERM, 1973

Nos. 73-437, 73-457, 73-464

MOBIL OIL CORPORATION,
PUBLIC SERVICE COMMISSION OF NEW YORK,
MUNICIPAL DISTRIBUTORS GROUP,
Petitioners

v.

FEDERAL POWER COMMISSION

INITIAL BRIEF OF PETITIONER MUNICIPAL DISTRIBUTORS GROUP

OPINIONS BELOW

The initial Opinion of the Fifth Circuit Court of Appeals and its Opinion on Rehearing have been made Appendices to the Petition for Certiorari filed by Mobil Oil Corporation in No. 73-437, and by agreement between this petitioner, Mobil Oil Corporation and the Public Service Commission of the State of New York,

and pursuant to permission of this Court, all three petitioners will use the Mobil Oil Appendices.[1]

The initial Opinion of the Fifth Circuit Court of Appeals is found at Appendix C, pp. 5-61 and its Opinion on Rehearing at App. B, pp. 3-4. These Opinions are not yet reported.

The initial Opinion No. 598 of the Federal Power Commission and its Opinion on Rehearing No. 598-A are reported, respectively, at 46 FPC 86 and 46 FPC 633. These Opinions have been provided to the Court by Mobil Oil Corporation in Part I of Volume 2 of the Joint Appendix in the court below.

JURISDICTION

The judgment of the Fifth Circuit Court of Appeals was entered on April 16, 1973 (App. A to Pet. p. 1), and the Petitions for Rehearing were denied June 11, 1973 (App. B to Pet. p. 3). By Order of June 20, 1973, Mr. Justice Powell extended the time for filing the Petition for Writ of Certiorari to September 10, 1973. The jurisdiction of this Court is invoked under 28 USC 1254(c) and § 19(b) of the Natural Gas Act, 15 USC 717r (b).

STATUTE INVOLVED

The Natural Gas Act, §§ 4, 5, 19(b), 52 STAT. 821, 15 USC §§ 717c, 717d, 717r, is set forth in App. D, pp. 65-69.

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[1] References to the Appendices will show the number of the volume, then the letter "A," then the page number, e.g., 2 A 432.

References to the opinion of the Court of Appeals under review will be to Mobil Oil Corporation's Appendix to Petition for Certiorari, e.g., App. C to Pet. 34.

QUESTIONS PRESENTED

1. Did the Fifth Circuit Court of Appeals err in holding that the Commission acted within its powers when it retroactively revised the refund order which it had previously issued in Docket No. AR 61-2?

2. Where the Federal Power Commission, in the first Southern Louisiana Area Rate Case (Docket No. AR 61-2), had ordered refunds of excessive rates charged by natural gas producers for gas committed to contracts prior to October 1, 1968, which refunds amounted to approximately $375,000,000, was the Fifth Circuit Court of Appeals in error in holding that the Commission acted within its powers in the instant Docket No. AR 69-1, when it approved a settlement proposal, not agreed to by all of the parties, and provided

(a) for an immediate reduction of the amount of the previously-ordered refunds by an amount of $225,000,000 and

(b) for the "work-off" of the remaining $150,000,000 of refunds by giving credits against individual producer refund obligations for natural gas subsequently committed to interstate commerce by such producers from the Southern Louisiana area,

where there was no statutory authority therefor, and where, assuming such statutory authority, there was no cost or other evidence whatsoever to support the figure of $225,000,000 for the immediate reduction in refunds, and where the provision for working off the balance of the refunds gave the greatest benefits to producers who had charged the highest rates in the past, and discriminated against producers which had charged lower rates in the past and against new pro-

ducer entrants in the Southern Louisiana area who had no pre-1968 production in that area?

3. Did the Fifth Circuit Court of Appeals err in approving the Commission's provision for contingent escalation in rates for flowing gas, where the producers which earned the rate escalation by dedication of new reserves would not be the same producers who benefited from the consequent escalation in rates, and where there was no cost or other basis for such escalations?

STATEMENT

Proceedings in Southern Louisiana I

On September 28, 1968, the Federal Power Commission issued its Opinion No. 546 and accompanying Order (40 FPC 530) in the first Southern Louisiana Area Rate Case. That Opinion, which was the culmination of seven years of investigation and litigation, established a composite national average cost per Mcf of gas which had been committed to contract prior to October 1, 1968 of 18.36¢ per Mcf, and found that the national average cost of new gas in the Southern Louisiana rate area was 18.80¢ per Mcf.

Upon these basic findings, the Commission established a price of 18.5¢ per Mcf for all natural gas subject to its jurisdiction in the Southern Louisiana area, which was committed to contract prior to 1961; 19.5¢ per Mcf for gas sold under contracts dated January 1, 1961 to September 30, 1968; 20¢ per Mcf for gas sold under contracts dated October 1, 1968 and thereafter. Gas not subject to the Louisiana severance tax was priced 1.5¢ per Mcf below the above figures.

Pursuant to the refund provisions of Section 4(e) of the Natural Gas Act (15 USC § 717c), the Commission required the respondent producers to refund all

rates in excess of the just and reasonable level for flowing gas, which had been collected by the producers subject to refund.

On Petitions to Rehear, the Commission issued its Opinion No. 546-A on March 20, 1969 (41 FPC 301) in which it held that, while the petitioners for rehearing had made no showing that the prices therein established would be inadequate to bring forth the optimum degree of industry effort to meet increasing demands for natural gas, nevertheless, the vital importance of future additional gas supply in the off-shore Louisiana area warranted the immediate commencement of future proceedings looking toward a possible upward revision of the price ceiling for new off-shore gas.

Opinion Nos. 546 and 546-A were appealed to the United States Court of Appeals for the Fifth Circuit, where the Commission was in all respect affirmed. *Austral Oil Company* v. *FPC,* 428 F.2d 407, *aff'd on rehearing,* 444 F.2d 125, *cert. denied,* 400 U.S. 950. While emphasizing that its judgment was an affirmance and not a remand, the Fifth Circuit Court of Appeals, on Petitions for Rehearing purported to grant to the Commission authority "to reopen *any* part of its order that circumstances require to be reopened . . . ." The court below made it part of the remedy "that the authority of the Commission to reopen any part of its orders, including those affecting revenues from gas already delivered, is left intact." (444 F.2d at 126).

Proceedings in the Present Case Before the Commission

The instant proceeding was initiated by the Commission on March 20, 1969 at Docket No. AR69-1 (41 FPC 378), where the Commission initiated an investi-

gation to determine whether the ceiling rates prescribed in Opinion Nos. 546 and 546-A for gas in the off-shore federal domain of the Southern Louisiana area should be raised. Pursuant to a large number of petitions, motions and replies, the Commission on December 15, 1969 enlarged the proceeding to include the entire geographical area of Southern Louisiana, onshore as well as off-shore, and to provide for a review of the just and reasonable rates for all vintages of gas produced therefrom. 42 FPC 1110.

Subsequently, a settlement conference was convened, and on November 6, 1970 the United Distribution Companies (UDC) consisting of 32 major privately-owned distribution companies, participating as a group, submitted a settlement proposal to the Commission. The Commission ordered it made a part of the record in the case. (2A 589). The proposal was subscribed to by the Associated Gas Distributors (AGD), another group of privately-owned distribution companies, and by all of the interstate pipelines and 46 natural gas producers. It was opposed by Mobil Oil Corporation, Amoco Production Company, the Public Service Commission of New York and MDG,[2] petitioner herein. After making the settlement a part of the record in the case, the Commission on its own motion consolidated the instant docket with Docket No. AR61-2 (the first Southern Louisiana Area Rate Case), reopened the latter docket, and received evidence for and against the settlement proposal.

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[2] The Municipal Distributors Group is composed of the Memphis Light, Gas and Water Division and over 200 other municipally-owned gas distributors who are members of the American Public Gas Association.

After presentation of evidence, and waiver of Initial Decision by the Hearing Examiner, the Commission issued its Opinion No. 598 and accompanying Order on July 16, 1971 accepting the settlement *in toto*.

The settlement provided the following rates:

For gas committed to contracts since October 1, 1968 (new gas) a rate of 26¢ per Mcf, both within and without the Louisiana taxing jurisdiction, with an automatic increase to 27¢ on October 1, 1974. This provided an immediate increase of 30% for gas subject to the Louisiana tax, and an increase of 40% for offshore gas, above the rates for new gas allowed in Opinion No. 546.

For gas committed to contract before October 1, 1968 (flowing gas):

Onshore (taxed)	22.375 cents
Offshore (untaxed)	21.375 cents

plus an automatic price escalation of .5 cents per Mcf on October 1, 1973. These rates were made subject to contingent escalation as follows:

When new gas reserves are committed to jurisdictional sales in Southern Louisiana before October 1, 1977, by whomever committed, the rates for all flowing gas will escalate at such time as follows:

at 7½ trillion cubic feet	.5 cents
at 11¼ trillion cubic feet	.5 cents
at 15 trillion cubic feet	.5 cents
Total	1.5 cents

The provisions made in the first Southern Louisiana Area Rate Case for refunds of excessive rates were drastically modified. In lieu of the refunds of ap-

proximately $376,000,000 required by Opinion No. 546, which consisted of all revenues which had been collected in excess of the rates there found to be just and reasonable, the refund obligation was unconditionally reduced to $150,000,000 by retroactively increasing the rates prescribed as just and reasonable in Opinion No. 546. The retroactive increases were as follows (2A 652-665):

Prior to January 1, 1965:

The rates were retroactively increased from 19.5 cents per Mcf to 20.625 cents onshore, and from 18 cents to 19.625 cents offshore, and refunds associated with such sales of gas were reduced by the difference between such rates.

January 1, 1965-September 30, 1968:

The rates were retroactively increased from 19.5 cents per Mcf to 21.25 cents onshore, and from 18 cents per Mcf to 20.25 cents offshore, and refunds associated with such sales of gas were reduced by the difference between such rates.

September 30, 1968-January 1, 1971:

Refunds were retroactively reduced for gas sales in this period to 30.5% of the difference between rates in effect on October 1, 1970 and those fixed in Opinion Nos. 546 and 546-A (as modified by Opinion No. 567).[3]

After January 1, 1971:

Refunds were limited on all rates in excess of ceilings established in Docket No. AR69-1.

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[3] Opinion No. 567 determined that gas from newly discovered reservoirs on already-committed leases should enjoy the higher price in effect upon discovery, and not the price at the date of the lease of the contract. 42 FPC 726 (1969).

The $150,000,000 of reduced refunds were subject to further reduction and entire elimination by refund "work-off" credits as follows:

Any company with a refund obligation to any natural gas pipeline company was allowed to reduce (or eliminate entirely) the refund obligation by one cent for each Mcf of new gas reserves committed in Southern Louisiana to a jurisdictional (interstate) market between November 1, 1970 and October 1, 1977, subject to extension of time within which the obligation could be reduced. (2A. 654, 666, 699).

THE DECISION BELOW

The Fifth Circuit Court of Appeals sustained the Commission on all points. It affirmed a rate of 26¢ per Mcf for all gas, both on-shore and off-shore, committed to contract after October 1, 1968. The court below also approved the rates established for flowing gas committed to contract prior to October 1, 1968, although it recognized that the new rate required flowing gas to "bear a portion of the burden for the exploration and production of new gas in the future," (App. C to Pet. 32), in addition to covering all of the costs and an adequate return on the flowing gas itself.

With respect to the refunds, the court below sustained the power of the Commission to reduce, and to provide for the complete elimination of, the refunds which had been ordered in its Opinion No. 546. As to the amounts thereof, the court below affirmed the reduction to $150,000,000 on the ground that there would have been an even greater refund reduction if the Commission had applied to the Opinion No. 546 re-

funds the flowing gas rates established in Opinion No. 598 (App. C to Pet. 43). Also, the Court held that—

> FPC does not *have* to order refunds under the terms of the Natural Gas Act. It *may* do so. (App. C to Pet. 43-44)

To the objection that the reduction in refund obligation benefited some producers more than others, the court below recognized that there was discrimination but held—

> We will not reject an administrative decision merely because one producer's piece of cake is iced and another's is not. (App. C to Pet. 45).

The court below affirmed the refund credit provisions of the Commission-approved settlement on the ground that the "FPC's statutory authority to order refunds is clearly discretionary," and that it "may tailor its refund orders to the particular needs of the industry in a given area." (App. C to Pet. 47, 48).

The Order affirmed the provisions for both automatic and contingent escalations in flowing gas rates on the ground that they were "a proper subject for the exercise of administrative discretion and clearly fall within that 'zone of reasonableness' which we allow FPC on review." (App. C to Pet. 50). To the complaint of certain producers that the escalation provisions made it competitively disadvantageous for them to commit new reserves to the jurisdictional market since such commitment would operate only to the benefit of their competitors, the reply of the court below was that "half a loaf is better than no loaf at all," and that the FPC has found that the provisions would provide incentive for some producers. (App. C to Pet. 50-51).

SUMMARY OF ARGUMENT

I.

The Commission by its orders herein, acting pursuant to a purported authorization by the Fifth Circuit Court of Appeals, has undertaken to re-open the findings and orders of an earlier area rate docket which had been affirmed by that court, and to change its orders in the earlier docket by providing for the elimination of refunds arising from natural gas rates found in the earlier docket to have been excessive and unlawful.

The Commission's orders herein with respect to such refunds are unlawful, because

(1) it had no power to re-open and "correct" its earlier final order, and the court of appeals had no power under Section 19(b) of the Natural Gas Act to authorize or order it to do so; and

(2) the elimination of refunds, which related mainly to gas sold, delivered and paid for during the period involved in the earlier docket, constituted retroactive rate-making of rates for the past, and was a grant of reparations to producers and the Commission has no power to fix rates retroactively or to grant reparations and the court of appeals cannot grant it such power.

II.

Even if the elimination of refunds ordered in an earlier docket did not exceed the Commission's statutory powers, its basis for doing so was arbitrary and totally unsupported by the record. It "corrected" its findings and rates in the earlier docket solely by applying cost figures presented in this docket to rates in effect during the earlier period covered by the re-

funds, and it never re-examined the facts underlying its findings in the earlier docket.

The Commission purported to justify its elimination of previously-ordered refunds by revising its earlier findings as to flowing-gas costs in effect during the period covered by the refunds. The revision was accomplished by a switch in the method for allocating exploration and development (i.e. dry hole) costs between oil and gas. The method used here (1) has been rejected by the Commission, in every other area rate case before and since the present one, as unreliable, and (2) was not here applied to the costs determined in the earlier docket, for the period covered by the refunds.

Even by its improper use of an unreliable costing method, the Commission staff was unable to find a cost of flowing gas high enough to justify elimination of the refunds. So it arbitrarily increased the rate for such gas by enough to make up the difference.

This arbitrary increase was purportedly justified on the ground that flowing gas costs should be made to "bear part of the responsibility" for the costs of finding new gas in the future. This justification fails because

(1) There is no evidence of any need for such a subsidy to the exploration costs of future reserves.

(2) Established regulatory law forbids requiring customers to contribute capital, then pay a return on it and pay for return of it;

(3) There is no assurance that the capital so contributed will be used for exploration for gas to be made available to the contributors.

III.

The overriding intent and purpose of the Natural Gas Act is to afford consumers a complete, permanent, and effective bond of protection from excessive rates and charges. The Commission has no discretion to violate this principle. The Natural Gas Act, therefore, requires that excessive rates and charges be refunded.

IV.

The industry scheme for a "work-off" of the remaining $150,000,000 of refunds by producers is arbitrary and discriminatory. The figure of $150,000,000 relates to nothing except the industry-selected settlement figure, and the Commission's after-the-fact attempts to relate it to costs are futile.

The "work-off" provisions discriminate in favor of those producers who have imposed the most excessive rates during the period covered by the refunds, and against the producers whose rates were lower, as well as against new producer-entrants into Southern Louisiana.

V.

The Commission's Order provided for four successive half-cent increases in rates for flowing gas in the future. The first half-cent increase, which would increase the value of proved reserves by $400,000,000, is automatic, and each of the others is successively triggered by the commitment of target figures of reserves to the interstate market in the future.

These increases, totally unrelated to costs, are not shown to be justified or needed—in fact are totally

unsupported by anything except the industry settlement proposal. Furthermore, they are discriminatory in that the benefits, which relate to reserves already being produced, bear no relation to the exploration and development efforts of the owners of the reserves. Those owners benefit from the efforts of their competitors, and of new producer-entrants who gain no benefit at all from the escalation.

ARGUMENT

I.

THE COMMISSION'S ELIMINATION OF A PART OF THE REFUNDS WHICH IT ORDERED IN SOUTHERN LOUISIANA I AND ITS MODIFICATION OF THE REMAINING REFUNDS, WAS AN UNLAWFUL RETROACTIVE AWARD OF REPARATIONS.

This Court has unequivocally held that the Commission has no power under the Natural Gas Act to fix rates retroactively, nor to award reparations. *FPC* v. *Hope Natural Gas Company,* 320 U.S. 591, 618 (1944); *Montana-Dakota Utilities Company* v. *Northwestern Public Service Company,* 341 U.S. 246, 254 (1951).

In Opinion No. 546 in *Southern Louisiana I,* the Commission, after seven years of litigation and exhaustive review of the evidence by the Trial Examiner and the Commission itself, found as a fact that the cost of flowing gas in the Southern Louisiana rate area, including a reasonable return, amounted to 18.36 cents per Mcf. Based upon this finding, it set a base area price for such gas of 18.5 cents per Mcf for pre-1961 gas and 19.5 cents per Mcf for gas sold under contracts dated January 1, 1961 through September 30,

1968. Where the Louisiana severance tax did not apply, the rates were reduced by 1.5 cents per Mcf (40 FPC 544).

In accordance with its usual practice, the Commission in its Order made provisions for refunds by the producers of rates which they had charged, pursuant to filings under Section 4(e) of the Act, which were in excess of the rates so fixed. (Id. at 626).

The refunds at that time related to gas which had been sold, delivered and paid for at the excessive rates prior to the Commission Order. Since the Commission Order was stayed pending appeal, the producers continued to charge the higher rates.

On Petition to Review Opinion No. 546, the Court of Appeals of the Fifth Circuit reviewed every element of the Commission Opinion and sustained the Commission's orders in full. *Austral Oil Company* v. *FPC,* 428 F.2d 407, 444 (1970). The court dissolved its stay of the orders in Opinion No. 546, without prejudice to the Commission's power further to stay its own order.

The effect of the Commission's Order and the court's affirmance, thus far, was clearly to establish the unlawfulness of the rates theretofore charged by most of the producers and to establish their obligations to refund the excessive portion of their rates.

However, on Petition for Rehearing, the Court of Appeals, in an unprecedented action purportedly taken pursuant to the general "equity power" of the Court, permitted the Commission "to reopen any part of its Order that circumstances require be reopened"

and to "make retrospective as well as prospective adjustments in this case if it finds that it is in the public interest to do so." 444 F.2d at 126. With respect to the refunds, the Court said:

> "it may be that the refunds are too burdensome in the light of new evidence to be in the public interest. In that case, it is our judgment that the Commission shall have the power and the duty to remedy the situation by changing its Orders." 444 F.2d 125, 126-127

The Municipal Distributors Group petitioned for certiorari from this element of the Fifth Circuit's Opinion, contending that the court had erred in permitting retroactive re-opening of a final order of the Commission, but certiorari was denied. (400 U.S. 950).[4] Before the final order of the Court of Appeals in *Southern Louisiana I,* the Commission had already initiated on March 20, 1969 in Docket No. AR69-1 (hereinafter referred to as *Southern Louisiana* II, which culminated in Opinion and Order No. 598 (I A 1-16)), a review of the rates established in Southern Louisiana I looking to prospective change, if found necessary, of such rates. On December 24, 1970, the Commission reopened the proceedings in Southern Louisiana I and consolidated them with those in Southern Louisiana II (1 A 352).

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[4] Petitioners were aware that the petition for certiorari at that stage in the proceedings might well be premature, in the absence of a final decision on the merits by the Commission. However, this court may in this proceeding consider all of the substantial federal questions determined in earlier stages of the litigation. *Mercer* v. *Theriot*, 377 U.S. 152, 153 (1964); *Reece* v. *Georgia*, 350 U.S. 85, 87 (1956); *Hamilton-Brown Shoe Co.* v. *Wolf Bros. Co.*, 240 U.S. 251, 257 (1916).

Meanwhile, the Commission had received on November 9, 1970 a Motion For Promulgation Of Settlement Proposal (1 A 139), the effect of which was to eliminate immediately the bulk of the refund obligations of the producers under Opinion No. 546 in Southern Louisiana I and to provide for a "work-off" of the remaining refunds by commitment of new reserves to the interstate market in the future. (1 A 652-653; 5 A 237e). The amount of the refunds, by the end of 1970, was $376,428,000. (5 A 237e).[5] The initial elimination accounted for $226,428,000, leaving $150,000,000 of refunds still owing. It was this remaining $150,000,000 which the Commission permitted to be "worked-off" by commitment of new reserves in the future.

The Commission arrived at its initial reduction of $226,428,000 by adopting the provisions of the settlement proposal which retroactively modified (and increased) the judicially approved just and reasonable rates for gas sold prior to September 30, 1968 (the date of the Opinion No. 546 in Southern Louisiana I) and also the rates for flowing gas sold under the same contracts after September 30, 1968 (2 A 652-653). Thus, the Commission, without any re-examination whatsoever of the record in *Southern Louisiana I*[6] substantially increased the rates and reduced the refunds fixed in that docket for gas sold under contracts dated prior to September 30, 1968.

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[5] The amount, with interest, would be much higher now. This is the same amount which the Court of Appeals refers to as $375,000,000 (App. C to Pet. 41).

[6] The total lack of record support for the Commission's modification of its earlier findings is discussed *infra*.

The action of the Commission clearly constituted retroactive ratemaking. Had its order in *Southern Louisiana I* gone into effect, the refunds would have been made to its customers in accordance with the usual and ordinary procedures under the Natural Gas Act. Its elimination of those refunds, by a retroactive increase in the rate levels fixed by Opinion No. 546, clearly amounted to a grant of reparations to the producers for the purpose of providing them with incentive and additional capital to search for new reserves in future years.

The findings, conclusions and orders of the Commission in *Southern Louisiana I,* establishing the just and reasonable rates for gas sold under contracts during the period involved in those proceedings, became final upon their unqualified affirmance by the Fifth Circuit in *Austral.* The jurisdiction of the reviewing court was limited by the review provisions of Section 19b of the Natural Gas Act (15 USC § 717r (b)) which provides in pertinent part:

> "Upon the filing of such petition [for review] such court [of appeals] shall have jurisdiction, which upon the filing of the record with it shall be exclusive, to affirm, modify or set aside such order in whole or in part
>
> * * *
>
> The judgment and decree of the court, affirming, modifying or setting aside, in whole or in part, any such order of the commission shall be final, subject to review by the Supreme Court of the United States upon certiorari . . ."

This Court, in construing the above language, held in *Tacoma* v. *Taxpayers of Tacoma,* 357 U.S. 320, 336 (1958), that Section 19(b)

> ". . . thereby necessarily precluded de novo litigation between the parties of all issues inhering in the controversy, and all other modes of judicial review . . . For Congress, acting within its powers, has declared that the Court of Appeals shall have 'exclusive jurisdiction' to review such orders, and that its judgment 'shall be final,' subject to review by this Court upon certiorari or certification."

The Commission in Opinion No. 598 very clearly demonstrated that it was considering *de novo* all the issues in the controversy. It said (2 A 645):

> "At the outset of this Opinion, we discussed the problems involved in following the Fifth Circuit's mandate, and conclude that we are examining *de novo* the matters discussed in Opinion Nos. 546 and 546-A."

The Commission has done precisely what the Natural Gas Act precludes it from doing.

The Commission has power to reconsider and correct its orders only until the time for judicial review has expired, and "the power to correct an order remains with the Commission until such time as the record on appeal has been filed with a court of appeals . . ." *Pan American Petroleum Corp.* v. *FPC,* 322 F.2d 999, 1004 (1963). There is no question but that the Commission purported, in its second opinion, to "correct" the findings which it made in its Opinion No. 546.[7]

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[7] Following affirmance and no remand or review by the Supreme Court the Commission's power is limited to changes that will have only prospective effect. Sections 4(e) and 5(a).

It stated (2 A 653) that "Opinion No. 546 did not afford an adequate return and it understated the requirements for exploration and development," and this was the basis for its retroactive change of the rates for flowing gas which had been established in Opinion No. 546. That retroactive change then became the principal basis for its elimination of refunds.

In *State Corporation Commission of Kansas* v. *Federal Power Commission,* 215 F.2d 176 (CA8, 1954), the regulated pipeline company was attempting to obtain a reduction in refunds ordered by the Commission in an earlier proceeding involving the pipeline's rates. The company contended that, although the Court had affirmed the Commission's earlier refund order, the actual cost of service for the year following the appeal of that order had exceeded the rates allowed by the Commission. The company sought to deduct from its refund liability an amount equal to the excess of its cost of service over the rates in effect during the year in question. The Court of Appeals denied the pipeline's motion, pointing out that:

> "If the stay in this case permitted Northern to override the Commission's Order and to collect from its customers the fund which it could not otherwise collect, *it devolves upon the Court upon affirmance of the Commission to order Northern to surrender the fund up to those other persons entitled to receive it.*" 215 F.2d at 182 (Italics supplied)

The court based its decision squarely upon the rule that

> "Under Section 4(e) the Commission may order a refund with interest of rates or charges which it

> has decided not to be justified, but its power to fix rates is prospective only and those it fixes are applicable only to the future." Id. at 183.

The Commission in this case, by purporting to reopen a final, judicially affirmed order in a prior docket, has clearly engaged in retroactive ratemaking, and by eliminating refunds relating to past periods, it has fixed rates applicable to the past.

This Court said in *Federal Power Commission* v. *Hope Natural Gas Company,* 320 U.S. 591, 618 (1944):

> "It is conceded that under the Act the Commission has no power to make reparation orders. And its power to fix rates admittedly is limited to those 'to be thereafter observed and in force.'"

The Fourth Circuit in the *Hope* case had spelled out the rule at greater length (*Hope Natural Gas Company* v. *Federal Power Commission,* 196 F.2d 803, 805):

> "The Commission's power to fix rates under section 5(a) is prospective only, and rates so fixed are applicable only to the future. * * * The Commission is given no power to enter reparation orders with respect to rates. Its power over rates, which is prescribed by section 5(a) * * * is to determine after a hearing whether existing rates are unjust, unreasonable, discriminatory or preferential, and, if so, to prescribe the just and reasonable rate 'to be thereafter observed and in force'. If it suspends a proposed new rate under section 4(e), and enters upon a hearing pursuant to that section, it can make only such orders with respect thereto 'as would be proper in a proceeding initiated after it had become effective', i.e. a proceeding under section 5(a)."

Since the Natural Gas Act gave the Commission no retroactive ratemaking power and no power to grant

reparations, it cannot justify its action in this case upon the Opinion of the Fifth Circuit in *Austral*. The power of the reviewing court to affirm, modify or set aside the Commission's order does not authorize it to add to the powers vested in the Commission by the Natural Gas Act. As this court has said with respect to judicial review of another administrative agency.

> "If broader powers be desirable, they must be conferred by Congress. They cannot be merely assumed by administrative officers; nor can they be created by the courts in the proper exercise of their judicial functions." *FTC* v. *Raladam Company,* 283 U.S. 643, 649 (1931)

In *State Corporation Commission of Kansas, supra* at 184, it was pointed out that

> "The court is also limited strictly to the exercise of judicial power and has no power to fix rates or to accord reparation on account of insufficiency of rates in the past . . . There is no place in the proceeding either for the Commission or the court to accord reparation
>
> * * *
>
> We conclude . . . That such recovery of reparation is not sanctioned by Section 19(b) and is contrary to well settled law."

This court held in *Montana-Dakota Utilities Company* v. *Northwestern Public Service Company,* 341 U.S. 246, 254, that the fact that Congress withheld from the Commission power to grant reparations does not require courts to entertain proceedings to obtain Commission action indirectly which Congress did not allow to be taken directly.

In the instant case, the Commission has undertaken to decide *de novo* an issue already finally decided in

Southern Louisiana I. In doing so it has attempted to "correct" a finding which had already been affirmed on appeal and was, therefore, no longer subject to its correction. The result has been a clear example of unlawful retroactive ratemaking, involving rates for gas much of which had been sold, delivered, consumed and paid for long before the docket was initiated. The reduction in refunds was in effect a grant of reparations which allowed the producers to retain rates which had been previously declared unlawful, and it did so for the avowed purpose of providing additional capital in the fond hope that it would be used in the search for gas in the 1970s.

What has been said above with reference to the initial elimination of $226,000,000 of refunds applies with equal force to provisions for "work-off" of the remaining $150,000,000 of refunds provided for in Opinion No. 598. The only difference is that the reparations with respect to the last $150,000,000 of refunds were made conditional upon certain actions of the producers. If the Commission lacks the power retroactively to change rates and grant reparations, then the addition of a condition does not improve the Commission's position.

II.

THE COMMISSION'S RETROACTIVE REFUND MODIFICATIONS ARE UNSUPPORTED BY EVIDENCE OR FINDINGS.

The foregoing argument demonstrates that the Commission erred as a matter of law in retroactively modifying rates which had been finally established and judicially affirmed in a prior docket. However, even if the law permitted such retroactive ratemaking on

the part of the Commission, its action in this case is still totally unjustified and arbitrary.

First, the Commission purported to modify its AR61-2 findings on cost of flowing gas by the use of evidence presented in AR69-1, which related to an entirely different period of time. Second, its basis for increasing the cost of flowing gas was not any real increase in experienced historical costs but only a switch in costing methods, and its new costing method is arbitrary and unsupported on its face. Third, when the switch in costing methods failed to produce as high a level for flowing gas as the industry's settlement proposal required, the Commission simply stuck on an additional amount, which it attempted to justify on the grounds that flowing gas costs should "bear a part of the responsibility" for the costs of exploration for new gas in the decade of the '70s. (2 A 647)

(a) The elimination of refunds cannot be justified by applying cost figures in the instant docket to rates in the earlier docket.

The provisions for the elimination of refunds were purportedly based at least in part upon findings that the cost of flowing gas as determined in the earlier Opinion No. 546 was inadequate, and that the cost found in that docket should have been 21.18 cents per Mcf instead of 18.36 cents per Mcf (2 A 653).

In reaching its conclusion as to the inadequacies of the Opinion No. 546 flowing gas rates, the Commission made no re-examination whatsoever of the record in that docket.[8] *Its entire discussion* of its justification

[8] The Commission stated (2 A 587): "As far as we are concerned, in the prescription of just and reasonable rates, Opinion Nos. 546 and 546A now perform no office."

for correcting the "inadequacies" of the Opinion No. 546 findings is contained in two sentences in its Opinion:

> "Opinion No. 546 did not afford an adequate return and it understated the requirements for exploration and development. In the light of these inadequacies, we find that the rates 20.625¢ and 21.25¢ as a base for refunds during the designated periods are reasonable and in the public interest." (2 A 654)

An examination of the record with respect to the two elements of cost mentioned by the Commission shows clearly the absence of any basis for this facile conclusion.

(1) Rate of Return

The Commission's discussion in this case of the issue of rate of return is found at 2 A 635-636 where, in three paragraphs the Commission discussed the rate of return *applicable to the present docket* and concluded that "the zone of reasonableness of rate of return is within the range of 13% to 16%" and "that a rate of return of approximately 15%, supported by the evidence in this case, is just and reasonable." (2 A 636).

It is obvious that the conclusion of the reasonableness of a 13% to 16% return based on the evidence in *this docket* (AR69-1) is no evidence whatsoever that the 12% return determined in Opinion No. 546 was inadequate for the times and circumstances relative to *that docket* (AR61-2). As this court stated in *Bluefield Water Works And Improvement Company* v. *Public Service Commission,* 262 U.S. 679, 692, "what annual rate [of return] will constitute just compen-

sation depends upon many circumstances and must be determined by the exercise of a fair and enlightened judgment, having regard to all relevant facts." Certainly the "relevant facts" confirming cost of capital change from time to time, so that a determination of the reasonableness of 13-16% in the 1971 opinion is in no way inconsistent with a determination of 12% in the 1968 opinion. There is no shred of evidence in this case that the return allowed in Opinion No. 546 was "inadequate."

The Court of Appeals completely ignored this issue. There is no mention of rate of return in its discussion of flowing gas rates (App. C to Pet. 31-32).

(2) Allocation of Exploration and Development Costs.

The only other basis cited by the Commission in justification for its "correction" of the Opinion No. 546 refund base is that the earlier opinion "understated the requirements for exploration and development" (2 R 653). Again, there is a total lack of any re-examination of the record in AR61-2. The Commission's conclusion is based solely upon the use of a new method for allocation of exploration and development expenses. The term "exploration and development expenses" refers to the costs of drilling dry holes, and the allocation problem is to divide these costs between oil and gas. The Commission had heretofore always used the "modified BTU method" for making this allocation, but in this case the Staff changed to the "direct assignment" method. *The entire discussion* by the Commission of this drastic change of methodology is set forth at 2 R 646:

> "Staff witness Engel departed from prior methodology only with respect to the determination of exploration and development expenses by refer-

ence to the directly assigned costs as reported by the respondents to the cost questionnaire; Staff counsel recommends that we make the same change, and MDG and New York Public Service Commission argue that we should not. Although we have some doubts about the evidentiary base furnished by the questionnaires, we also have doubts about the modified Btu method followed in past cases, with the inherent variables of a judgmental factor. In Opinion No. 546, this factor was 3.5, while staff witness Raymond D. Murr (Supervising General Engineer) and Producer witness Donald W. Auten recommended this be 2.5. We accept staff's recommendation to use the new methodology. The difference in result of about one cent per Mcf is more than accounted for by the range of estimates presented to us in the other choices implicit in the flowing-gas costing methodology."

The issue was brushed aside by the Court of Appeals with the footnote explanation that the change "may have accounted for 1¢ Mcf difference", but that such difference "is more than accounted for by the range of estimates presented to us in the other choices implicit in the flowing gas costing methodology." (App. C to Pet. 31)

The fact is that the change in allocation method more than accounted for the *entire increase* in cost of flowing gas over that which had been determined in Opinion No. 546. A comparison between the Staff's cost computation in this case and a computation based upon application of the Opinion No. 546 method to the facts and figures of this record, using a 13% return, shows the difference in the exploration and development cost to be nearly 3¢, and shows that such difference more than accounts for the total change in costs:

	Staff Witness Engel [9] 13% Return 2 A 688 Converted to 15.025 psia	MDG Witness Wiskup 13% Return 5 A 231e Ex. 83, Sch. 1 at 15.025 psia	Difference Engel over (under) Wiskup
Production Expense	1.84¢	1.88¢	(.04¢)
D.D.&A	4.08	4.11	(.03)
Regulatory Expense	.17	.17	–0–
Gathering Cost	.51	.51	–0–
Return	5.58	5.56	.02
Production Tax	2.30	2.30	–0–
Total Production	14.48¢	14.53¢	(.05¢)
E&D	5.58	2.96	2.62
Return	1.12	.80	.32
Total E&D	6.70¢	3.76¢	2.94¢
Total all costs	21.18¢	18.29¢	2.89¢

In this regard, it is worthy of note that the Fifth Circuit, *In Re: Other Southwest Area Rate Case,* 484 F.2d 469, 482 (1973), remarks upon the allegation of a producer that the "direct assignment" method in that case would have made 6.17¢ per Mcf difference in the flowing gas rate for the Other Southwest Area, and noted the Commission's failure to take issue with the allegation.

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[9] Also set forth in Opinion No. 598, 2 A 647. The slight differences in the first column from the figures shown in the Appendix and the Opinion are caused by conversion of each cost element from 14.065 psia to 15.025 psia instead of converting the subtotal as in the Opinion and Appendix.

The second column also shows there was no actual increase in costs of flowing gas between the two dockets. The cost, per Opinion No. 546, was 18.36¢.

The "direct assignment" method of allocating exploration and development costs is nothing new. It has been proposed by the producers in the *Permian* case and in every succeeding area rate case, and it has been emphatically rejected by the Staff, Examiners and the Commission in every case except this one. The reasons expressed by the Commission and Examiners in earlier cases were consistent and persuasive. In the *Permian* Opinion No. 468, the Commission said with reference to the direct assignment method (34 FPC 159, 217):

> "We may also note that in the allocation of developmental dry hole costs, there was a considerable degree of self-selection in the responses from the polled producers. Expressions of 'intention' also involved subjective considerations. The data obtained are not the result of a random sample of all producers on an objective basis and do not offer a reliable foundation for fixing prices."

A similar conclusion was reached by the Examiner in Southern Louisiana I, (40 FPC 812), and adopted by the Commission (Id. at 594).

In the *Texas Gulf Coast Area Rate Proceeding* (45 FPC 674, 859 (1971), the Presiding Examiner again discussed and rejected the direct assignment method on the grounds that it was based on subjective standards, there was no assurance of objectivity, and the reporting standards of the individual companies were not uniform. In *Public Service Commission, State of New York* v. *FPC,* 487 F.2d 1043, 1060-61 (1973), the Fifth Circuit upheld the Commission's use of the modified BTU method in the Texas Gulf Coast Area. The same method was again used by the Commission in the *Other Southwest Area Rate Case, supra,* 482.

The same defects in the direct assignment method which convinced the Commission of its unsoundness in all the other cases are present in this docket. The direct assignments of the costs of each dry hole were made to the product (oil or gas) which the *producer said* it had hoped to find at the bottom of the well, i.e. the "primary objective of the search" (Exhibit 69, Packet B, Sch. 3).

However, Staff witness Fell who presented the exhibit on the direct assignment method did not know exactly how the companies went about assigning dollars to particular drilling efforts prior to the beginning of drilling. (4 A 619) He did not know precisely where the figures were taken from (Id. 620). He did not know whether all the companies used the same standards or tests or criteria to make the decision whether the well was drilled in search of oil or gas. (Id. 620). The same problem with respect to self-selection and a lack of a random sample appears in this case. Of $1.257 billion of exploration and development expenses reported, only $552,107,000 was assigned by the responding producers to reservoirs. (5 A 194e). Of sixty-eight companies which responded to Staff's direct assignment questionnaire, only fifty-six chose to respond to the questions in Packet B, which provided the information from which the direct assignments were made (R. 6312) [10]

In view of the fact that the direct assignment method allocates to gas reservoirs 45% of total dry hole costs (5 A 194e) it is significant that gas revenues ac-

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[10] The Appendix at 4 A 602 includes only 30 of those companies, which is an incomplete list.

count for only about 20% of total oil and gas revenues, and only 5% of total revenues of the major producing companies. (3 A 350-351)

The Commission's adoption of the direct assignment method in this case is unique. Since the method has been rejected by it in each area rate case both before and since the present one, there can be only one reason for its adoption here: a desperate attempt to shore up the Commission's uncritical acceptance of the settlement proposal arrived at by the producers, pipelines and investor-owned distributors. While the Commission has power to choose between methods of computation of elements of cost of service, that power is limited to conclusions based upon findings which have adequate support in the evidence of record. (*Burlington Truck Lines* v. *United States,* 371 U.S. 156, 168 (1962); *Atlantic Ref. Co.* v. *Pub. Serv. Comm. of New York,* 360 U.S. 378 (1959)). The Commission's action in this case, totally inconsistent with every other decision which it has made on this issue, and unsupported by any reasoning or analysis, must be treated as arbitrary and invalid.

In addition, the Commission's "correction" of its allocation method in *Southern Louisiana I* is fatally defective because the new method *was never applied to the costs in the earlier docket.* The study of Staff witness Engel relied upon by the Commission, (2 A 647) relates solely to the costs as they appear from the evidence submitted in AR69-1, and Engel's total flowing-gas cost of 21.18¢ is derived exclusively from that record. This provides no evidence whatsoever as to the level of flowing-gas costs in the earlier docket, nor does it show what that level would have been if

the direct assignment allocation method had been applied in AR61-2. Therefore, the Commission acted without any semblance of evidentiary support when it concluded that "Opinion No. 546 . . . understated the requirements for exploration and development." (2 R 653).

The above analysis reveals the error of the Court of Appeals in affirming the refunds on the basis that:

> "If the refunds had been calculated on the basis of the rates established for flowing gas and approved by us in this Opinion, they would have been substantially less than the $150,000,000 about which some consumers complain. Thus, we hold that the evidence amply supported the reduction in the amount of total refund ordered in SoLa II." (483 F.2d at 995)

The court's conclusion is based upon the assumption that the Commission's increase in flowing gas rates from 18.5¢ in *Southern Louisiana I* to 22.375¢ in the present case is justified by the record. This assumption is clearly erroneous, as above demonstrated. There was no re-examination of the *Southern Louisiana I* record, and, therefore, no basis for increasing the rates for gas sold during the period covered thereby. Even on the present record, and using the switch in allocation methods, the Staff was able to arrive at no higher a cost of service for flowing gas than 21.18¢; the rest of the 22.375¢ was added for the sole purpose of forcing a balance with the settlement figure.

Since the court's assumption underlying its above conclusion is demonstrably unfounded, the conclusion itself must fall.

(b) The Commission and Court of Appeals erred in requiring rates for flowing gas to "bear responsibility" for costs associated with future reserves.

(1) No need has been demonstrated for a subsidy to new gas.

While the Commission attempted to sustain its elimination of refunds upon a finding of an increase in the costs involved in AR61-2, its real rationalization for the increase makes this attempt immaterial. In fact the Commission said that "to argue that there has been no increase in the unit cost of flowing gas since the AR61-2 test year of 1960 really begs the question." (2 R 645). The Commission (2 R 645) and the Court of Appeals (App. C to Pet. 32) present the real issue as: "whether flowing gas realizations should bear a part of the responsibility for assuring a gas flow to meet the needs for a heightened exploration and production effort."

To the extent that the rates for gas sold, consumed and paid for prior to 1970 are required to subsidize revenues from gas still to be discovered in the future, this "responsibility" is a non-cost additive to rates for new gas. The additional "responsibility" imposed upon flowing gas bears no conceivable cost relationship to gas which is to be found in the future. The costs of that gas were considered by the Commission, and it came up with a cost computation which purported to support the settlement figure of 26¢ per Mcf. (2 R 638). That cost computation is totally independent of the costs of flowing gas, which were assessed by the Commission in a completely separate computation. (2 A 647). Therefore, the extent of the contribution made by the flowing gas rates, over and above the cost of that gas, is a non-cost additive. When the Com-

mission uses non-cost elements to determine a rate, such elements "should be clearly labeled as such and their basis explained as specifically as possible, and they may be used only if they are clearly identified and explained." *Southern Louisiana Rate Cases* v. *FPC,* 428 F.2d 407 (CA5, 1970). Neither the Commission nor the Court of Appeals has provided any explanation for their decision that flowing gas rates must contribute to the future search for gas. The Court of Appeals states only that

> ". . . we cannot ignore FPC's determination that the extra earnings to be acquired through income for flowing gas at the increased rate would generate additional, needed, internal capital available for expenditure in the search for new gas reserves." (App. C to Pet. 32)

However, neither the Commission nor the Court of Appeals has presented an answer to the problem expressed by the Court of Appeals for the District of Columbia in the *Texas Gulf Coast Case,* 487 F.2d at 1072:

> "If, as must be assumed, prices have been set for new gas that fully reflect the cost of exploration, including failures and the cost of attracting money (rate of return) to the exploration enterprises, then it is difficult to discern the argument for an extra allowance on existing gas flows, in the interest of providing an incentive to explore for *new* gas."

In the present case the Commission has expressly held that the new-gas rates "should attract new entrants to the industry." (2 A 629). Since the new entrants would have no flowing gas reserves in Southern Louisiana, they would be forced to rely en-

tirely upon the 26¢ rate for new gas as the only incentive for investing in the area. If the new gas rate is adequate to attract new producers, then it obviously provides an adequate coverage of costs, an adequate rate of return, and an adequate incentive to search for gas. Nothing more could possibly be needed.[11]

The effect of requiring flowing gas to bear responsibility for future exploration is to grant to existing Louisiana producers an extra benefit, relative to their future exploration, which is not shared by the new producer entrants in the area. There is no attempt to explain why producers already in the area should need *more* incentives than those which will be attracted by the 26¢ rate alone.

The Commision has failed to explain this non-cost element, and its attempted explanation is inconsistent with its other findings in the case. The Court of Appeals' justification that the increased rate "would generate additional, and needed, internal capital available for the exploration for new gas reserves" (App. C

[11] Since the final order in this proceeding, the Commission has taken action pursuant to Order 455 in Rulemaking R-441, Optional Procedure for Certificating New Producer Sales of Natural Gas, 48 FPC 218 (1972), to facilitate the certification of future sales of natural gas at rates considerably higher than those provided in Opinion No. 598. Its latest opinion and order in *Southern Natural Gas Company, et al,* Opinion No. 686, — FPC —, January 1, 1974, allows a producer in Alabama 55¢ per Mcf for new gas. In its area rate proceeding *Permian Basin Area II* (50 FPC —, Opinion No. 662 (1973)), the Commission raised the applicable rate for the Permian Area to 35¢. There seems to be no question but that the 26¢ rate for new gas in Southern Louisiana is due for an early increase, either by way of the optional procedure or otherwise. If the 26¢ rate alone and without any subsidy from flowing gas rates was adequate, the new rates in prospect should be even more so.

to Pet. 32) fails to resolve this defect in the Commission's reasoning. Again, in the words of the Court of Appeals for the District of Columbia,

> "This is not an explanation but a conclusion . . . No semblance of analysis is indicated, in terms of the consequences upon industry structure from the provisions, nor is any reasoned consideration given to the alternative of an increase in the new gas price. 487 F.2d 1074.

(2) The requirement that customers contribute capital to the producers is unlawful.

The Court of Appeals resolved in favor of the Commission and producers the legal issue of "whether flowing gas must bear a portion of the burden for the exploration and production of new gas in the future." (App. C to Pet. 32)

The Court did so because

> ". . . we cannot ignore FPC's determination that the extra earnings to be acquired through income for flowing gas at the increased rate would generate additional, and needed, internal capital available for expenditure in the search for new gas reserves." (Id.)

If customers are required to "generate additional, and needed, internal capital", then they are providing what is ordinarily the responsibility of the shareholders to furnish. Under the Commission and Court's holdings, the rate-payer must provide the capital, then pay a return on the capital, and then pay for the recovery of the capital through depreciation and depletion.

This is unjust and unreasonable on its face and is contrary to traditional utility concepts. The same Court of Appeals recognized this fact in *Alabama-*

Tennessee Natural Gas Co. v. *FPC,* 359 F.2d 318 (1966) (cert. denied 385 U.S. 847), where the Court said:

> "Under traditional regulatory concepts, utility company shareholders (investors), not the consumer, furnish the capital necessary for the operation of the business. *Railroad Commission of Louisiana* v. *Cumberland Telegraph and Telephone Company,* 1909, 212 U.S. 414, 424, 29 S.Ct. 357, 53 L.Ed. 577; *Lindheimer* v. *Illinois Bell Telephone Company,* 1934, 292 U.S. 151, 169, 54 S.Ct. 658, 78 L.Ed. 1182. The consumer pays a fair return on the utility's capital and in addition pays the cost of operation including taxes, but:
>
> '. . . [I]f the amounts charged to operating expenses and credited to the account for depreciation reserve are excessive, to that extent subscribers . . . are required to provide, in effect, capital contributions . . . to secure additional plant and equipment upon which the utility expects a return.' *Lindheimer,* 292 U.S. at 169, 54 S.Ct. at 665."

If it is unreasonable and unlawful to require the customer to contribute capital to the producer in the ordinary case, it is even more so when this extraordinary benefit is applied only to the producers who already have reserves in south Louisiana, and not to the new entrants. There is obvious discrimination in requiring contribution of capital by the customers to some of the regulated companies and not to others.

Such a result also completely belies the Commission's conclusion that the settlement rates will promote competition.

(3) There is no finding nor evidence that the additional capital provided by the customers will be spent for gas exploration for sales in interstate commerce.

The justification used by the Commission and adopted by the Court of Appeals for all of the non-cost elements of the rate is the shortage of gas and the need for providing ample funds and incentive to obtain more reserves for the interstate market.

A fatal defect in the reasoning of the Commission and Court is the total absence of any reasonable assurance that the additional capital contributed by pre-1970 customers of gas will in fact be used for searching for gas in the post-1970 period. There is no requirement that the producer devote his additional earnings in excess of cost to a search for gas for the interstate market. The producers through their representative witness, Mr. Vaughn, Vice-President of Union Oil Company of California, testified as to how the industry makes its investment decisions each year with respect to available capital funds. Mr. Vaughn testified that, in considering an investment decision by a producer,

> "The main economic factors are an estimate of the profitability of the project, a judgment of the risk of the project, and the availability of resources with which to undertake the project." (3A 220).

Nowhere in Mr. Vaughn's extensive testimony on this subject is there the slightest indication that a producer will incline to invest capital in the search for gas for the interstate market merely because the revenues came from that market. It is obvious that the large producers have a wide range of prospective investments for their capital, which involve exploration and pro-

duction in many other areas of the world beside Southern Louisiana, and involve many investment opportunities other than the search for gas. (3A 223). The witness made it clear that there could be no division of capital between oil and gas in the offshore area of Southern Louisiana. He said:

> "Well, in the offshore areas of Southern Louisiana, here I would say that, no, we can't separate gas only from the liquids because in almost every instance in south Louisiana we are looking for both." (3R 345).

Another witness testifying in favor of the settlement was Mr. John G. Winger, Vice-President of Chase Manhattan Bank and Manager of the Bank's Energy Economics Division. Mr. Winger said of producers generally:

> "When he embarks upon a search for petroleum reserves, in most instances he is motivated by his desire to find oil, not gas. He wants to find the most valuable hydrocarbon." (4A 483).

Mr. Winger further agreed that:

> "If the price of gas is increased and thereby produces a greater reservoir of funds for exploration and development, the producer is nevertheless going to be interested in developing or in searching for the most valuable product, and that would be oil." (4A 483).

In the absence of any evidence contrary to the above, there is no factual basis in the record to support the Commission's tentative and uncertain conclusion that:

> "We find it unlikely that producers, already involved in the Southern Louisiana area, will decide not to expand their exploratory and drilling efforts." (2A 648).

If that finding is not supported, then the entire basis for the Commission's treatment of the refunds is destroyed. There then remains no answer to the objection recognized by the Commission that

> ". . . to look to flowing gas revenues to enhance the exploration effort is to countenance a possible windfall to producers who would not . . . be required to commit the increased revenues to development in the area." (Id.);

nor to the conclusion of the Fifth Circuit as to

> "the lack of any assurance that revenues generated by even the most generous of incentive rates will be invested in new production of reserves of interstate gas. Among large integrated producers there is always competition between oil and gas in the use of the dollars. And among all, the choice is even more severe as between *intra* and *inter* state gas sales." (App. C to Pet. 44)

Further support for that conclusion is found in the statement by Judge Leventhal in *Public Service Commission* v. *Federal Power Commission,* 487 F.2d 1073, 1074 (Texas Gulf Coast Area Rate Case):

> "What determines the decision to make an investment is the estimate of earnings from the new investment, and if that is projected as a return that justifies the risk, capital will be available. Similarly, if the projected returns do not justify the risk, capital will not be invested even though retained earnings are available from current operations. Firms must assess the opportunity cost of investing their retained earnings in new exploration, as opposed to other uses in active, or even passive, investment opportunities."

The above considerations make it clear that it is not enough to provide producers with additional capital. If such action is to be of any value to the consumers who pay the tariff, there must be some provision for assuring that the extra revenues are applied for their benefit, and not primarily for the benefit of stockholders. In the absence of any such assurances in this case, the taxing of the customers of the 1960s with $375,000,000 of non-cost additions to their rates is totally arbitrary and an abuse of discretion.

The evidentiary basis relied upon by the Commission and approved by the Court of Appeals for the retroactive increase in costs and resulting decrease in the refunds found to be proper in Southern Louisiana I is utterly without support in the record, and they constitute arbitrary action on the part of the Commission. The principle stated by Judge Leventhal in *Public Service Commission* v. *Federal Power Commission* is pertinent:

> "While the task of justifying price methods which depart from pure costs poses difficult problems, due to the difficulty in understanding demand and supply elasticities of natural gas, this state of the art cannot be used as an excuse to offer no reasons for adopting these measures, or to supply reasons which have no basis in evidence and underlying reasoning." 487 F.2d at 1054

That principle, applied by the Court of Appeals for the District of Columbia in respect to the Texas Gulf Coast area rates has equal application to this case.

III.

THE COMMISSION DOES NOT HAVE DISCRETION TO WAIVE REFUNDS.

The Court of Appeals affirmed the elimination of refunds on the additonal ground that

> "FPC does not *have* to order refunds under the terms of the Natural Gas Act. It *may* do so. (App. C to Pet. 43-44)

While Section 4(e) of the Natural Gas Act uses the word "may" [12] this language does not imply that the Commission has discretion to refuse to order refunds of amounts unlawfully charged by regulated companies in excess of just and reasonable rates. The overriding intent and purpose of the Natural Gas Act is "to afford consumers a complete, permanent and effective bond of protection from excessive rates and charges." *Atlantic Refining* v. *Public Service Commission,* 360 U.S. 378, 388 (1950). All actions taken by the Commission are subject to this principle, and the Commission has no discretion to violate it.

The fact that a statute uses the word "may," rather than "shall" does not give the enforcing authority the privilege to ignore the provision at its whim. See

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[12] "Where increased rates or charges are thus made effective, the Commission may, by order, require the natural-gas company to furnish a bond, to be approved by the Commission, to refund any amounts ordered by the Commission . . . and, upon completion of the hearing and decision, to order such natural-gas company to refund, with interest, the portion of such increased rates or charges by its decision found not justified." § 4(e), 15 U.S.C. § 717c(e). The Commission in this docket did not purport to be acting under Section 4, but rather under "the provisions of the Natural Gas Act, particularly but not in limitation of the foregoing, Sections 5, 8, 10, 14 and 16 thereof . . ." (1A 8)

Supervisors of Rock Island County v. *United States ex rel State Bank,* 71 U.S. 435, 18 L.Ed. 419, 493 (1867), where this Court said

> "The conclusion to be deduced from the authorities is, that where power is given to public officers, in the language of the act before us, or in equivalent language—whenever the public interest or individual rights call for its exercise—the language used, though permissive in form, is in fact preemptory. What they are empowered to do for a third person the law requires shall be done. The power is given, not for their benefit, but for his. It is placed with the depository to meet the demands of right, and to prevent a failure of justice. It is given as a remedy to those entitled to invoke its aid, and who would otherwise be remediless."

Again in *Mason* v. *Fearson,* 50 U.S. 248 (9 Howard), 13 L.Ed. 125 at 130 (1850), this Court recognized that

> "Where a statute directs the doing of a thing for the sake of justice, or the public good, the word 'may' is same as the word 'shall.' . . ."

The Court went on to say

> "Without going into more details, these cases fully sustain the doctrine, that what a public corporation or officer is empowered to do for others, and it is beneficial to them to have done, the law holds he ought to do. The power is conferred for their benefit not his; and the intent of the legislature, which is the test in these cases, seems under such circumstances to have been "to impose a positive and absolute duty."

A long line of cases supports this proposition: *Michaelson* v. *United States ex rel. C., St. P., M and O.R. Co.,* 266 U.S. 42 at 70, 69 L.Ed 162 (1924); *In re Chicago, R.I. & P. Ry. Co.,* 162 F.2d 606 at 611 (CA7, 1947); *McAndrews* v. *Belknap* (CA6,

1944) 141 F.2d 111; *Wilson, et al.*, v. *United States*, 135 F.2d 1005 at 1009 (CA3, 1943); *Fidelity & Casualty Co. of New York* v. *Brightman*, 53 F.2d 161 (CA8, 1931); *United States ex rel. Harrisman Nat. Bank* v. *Caplinger*, 18 F.2d 898 (CA8, 1927)."

This Court has said, with specific reference to the duties of the Commission:

> "It is, therefore, the duty of the Commission to look at 'the backdrop of the practical consequences resulting * * * and the purposes of the Act, *Sunray Mid-Continent Oil Co.* v. *Federal Power Comm'n*, 364 U.S. 137, 147, 80 S.Ct. 1392, 1399, 4 L.Ed. 2d 1623 (1960), in exercising its discretion under § 16 to issue interim orders and, where refunds are due, to direct their payment at the earliest possible moment consistent with due process." *FPC* v. *Tennessee Gas Transmission Co.*, 371 U.S. 145, 155 (1962)

The same principle which governs the exercise of the Commission's discretion under Section 16 of the Act to direct the payment of refunds "at the earliest possible moment consistent with due process" applies equally to the Commission's duties under Section 4 of the Act.

IV.

THE SCHEME FOR "WORK-OFF" OF REDUCED REFUNDS IS ARBITRARY AND DISCRIMINATORY.

(a) The amount of remaining refunds is arbitrary.

The Commission's treatment of the $150,000,000 of refunds which remained after its initial reduction is merely an adoption of the settlement proposal arrived at among some of the parties. Despite the efforts of the Commission to shore up its adoption of the settlement proposal by after-the-fact rationalizations, both the amount of the refunds and the provisions for

"work-off" of the producers' obligations thereunder remain totally arbitrary. In addition, they create blatant discriminations in favor of the producers who in the past charged the most excessive rates and against those producers whose rates in the past have been most nearly reasonable.

In the first place, the figure of $150,000,000 of refunds was not arrived at upon any rate-making theory, principle or analysis, but was solely the product of negotiation among certain of the parties. The refund figure of $150,000,000 was reached first, and then the change in the rates established in Opinion No. 546 was manipulated so as to arrive at that predetermined total. This was the reason for increasing the rates prior to January 1, 1965, from 18.5 cents to 20.625 cents on shore and 19.625 offshore; for increasing the rates from January 1, 1965, to September 30, 1968, from 19.5 cents to 21.5 cents on-shore and 20.25 cents off-shore; and for increasing the rates from October 1, 1968, to January 1, 1971, by whatever amount was necessary to make up the $150,000,000 figure. (2A 652-653)

In its Opinion (2A 652), the Commission attempts to identify its new pre-January 1, 1965 rates with the settlement level in the *Union Texas Petroleum* cases, 32 FPC 254, 952 (1964). These were not rate cases, but certificate cases. The "in-line" rates there established were not those herein adopted by the Commission, but 18.5 cents off-shore and 20 cents on-shore.

The Commission states in a footnote (2A 653) that its January 1, 1965–September 30, 1968, level of rates is the same as that established in its Statement of General Policy 61-1, 26 FPC 661 (1967). That was not a rate case, but was an interim rate established tem-

porarily, pending the determination of the just and reasonable rate in Southern Louisiana I. The off-shore rate there fixed was not 20.25 cents, as adopted here, but was 19.5 cents.

Thus another attempt of the Commission to shore up its determination to accept every detail of the settlement which the industry proposed falls far short of finding justification in the record or rationale.

(b) The "work-off" provisions are discriminatory.

Having arbitrarily eliminated $226,000,000 of refunds in order to reach the $150,000,000 level proposed in the settlement agreement, the Commission, still precisely following the settlement proposal, provided for the waiver of most or all of the remaining $150,000,000 by granting credits to producers for new gas reserves committed to the interstate market. (2A 693-699).

The credit is one cent for each Mcf of reserves committed by the producer to the purchaser to whom the refund is owed. But that is not all. The producer may also pay off his refund obligation to Purchaser A by committing new reserves to Purchaser B. This happens if Purchaser A rejects the offer of the new reserves. It also happens if a producer commits to any purchaser more than enough reserves to pay off his refund obligation to that purchaser. The excess refund credit goes to reduce all other refund obligations of the producer — even though the refund obligees receive nothing (Settlement Sec. 8.2, 2A 696-697).

The discrimination inherent in these refunds provisions is clearly apparent:

(1) The producers who have charged the most unreasonable rates in the past are the greatest benefi-

ciaries, and those whose rates have been unreasonable get no benefit.[13] In fact, of the original refunds required by Opinion No. 546, about one-third of the total was owed by three companies, the California Company, Shell Oil Corporation, and Superior Oil Co. (Ex. 99; 5A 253e)

(2) All benefits accrue to producers already in Southern Louisiana and none to any new producer entrants into the area, thereby imperiling the entry of new producer entrants and giving a competitive advantage to producers who had charged the most unreasonable rates in the past.

(3) A pipeline to whom a refund is owed may be deprived altogether of the refund (which it is under obligation to pass on to its customers) if the reserves tendered to it are in an area which its lines do not reach; or if its producer-obligor finds and commits to a competing pipeline a large reserve which provides enough credits to soak up all the producer's obligations.

It is not difficult to understand why the pipelines, and groups which adopted the name United Distribution Companies and Associated Gas Distributors are so cavalier in their attitude toward the substantial refunds owed by the producers. They are all privately-owned companies, regulated by the Commission or by State Commissions, and they would doubtless be required to pass along most, if not all, refunds to the consumers. They were negotiating largely with other

[13] The details of this discrimination have been spelled out by Mobil Oil Corporation and Amoco Production Company in their briefs to the Commission and Court of Appeals, and will doubtless be repeated by those petitioners here. Accordingly, this brief will not be extended by a rehearsal of those details.

people's money, and some of them had conflicting interests as producers of natural gas.

This made it all the more necessary that the Commission review carefully and independently the grounds and effects of the refund provisions. A majority vote of the negotiators is not enough. Yet this appears to be the basis of the Commission's acceptance of the refund provisions. Although the Commission recognized

> "... that one group is in effect rewarded for their relative intransigence"

and that

> "Candor requires us to admit that some of the predicted inequities as among producers will surely occur, and those who have attempted to work 'within the system' are comparatively disadvantaged" (2R 600)

nevertheless, said the Commission,

> "The broader acceptability of the settlement proposal within the distributor group impels us to act as we do." (2R 600) [14]

Nothing could more clearly reveal the dangers of such regulation by negotiation.

The Court of Appeals reviewed the complaints by Amoco and Mobil that the work-off provisions with respect to the $150,000,000 of refunds were discrimi-

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[14] The Court of Appeals paradoxically took comfort from the fact that the proposal was "stridently opposed by Amoco, Mobil, MDG and the New York Public Service Commission" (App. C to Pet. 21), assuming this to be evidence of "consideration, both pro and con, of all sides of the problem." (Id.) The Court overlooked the fact that MDG and New York were the only active participants whose first loyalty was to consumers, rather than stockholders.

natory and unfair; it made no attempt to answer any of those allegations or to deny their validity. It merely cited the *Hugoton-Anadarko Area Rate Case,* 466 F.2d 974 (CA9, 1972), which had affirmed a "particular allowance" for the position of Phillips Petroleum Company and concluded "the same rationale which supports FPC's discretion in granting a special dispensation in Hugoton-Anadarko likewise supports its discretion in OP: 598. Such is the essence of administrative discretion." (App. C to Pet. 49)

In *Hugoton-Anadarko,* the Commission had made a special refund provision for Phillips Petroleum Company in order to "avoid a result which would have treated Phillips unfairly as to the other producers." 466 F.2d at 990. It is ironic that the Fifth Circuit should justify a provision creating discrimination by citing an action of the Commission which was taken to avoid discrimination.

V.

THE SETTLEMENT PROVISION FOR ESCALATION OF RATES FOR FLOWING GAS IN THE FUTURE IS ARBITRARY, DISCRIMINATORY, AND UNSUPPORTED ON THE RECORD.

The Commission in Opinion No. 598 has provided for a total of four future increases in rates for flowing gas.[15] A half-cent automatic increase was provided for

[15] These petitioners do not here attack the new base rates fixed by the Commisison to be charged for flowing gas in the future. The Commission has power to change future rates, regardless of the date of the contract under which the gas is being sold (assuming there are no contractual inhibitions against such a change). Despite the unsatisfactory status of the record concerning the establishment of prices to be observed in the future for gas already committed to contract, petitioners have chosen, as policy matter, not to attack those base rates. The petitioners' attack, therefore, is limited to the future escalations of those rates.

October 1, 1973 (2A 680) and three additional half-cent increases were allowed, contingent on dedication of new reserves in Southern Louisiana by October 1, 1977, in accordance with the following formula:

> .5 cents for 7.5 trillion cubic feet (TCF) of new reserves;
>
> .5 cents more when the total of new reserves reaches 11.25 TCF;
>
> .5 cents more when the total of new reserves reaches 15 TCF (2A 649)

These increases were, of course, all provided for in the settlement. They were all non-cost items.

As to the automatic half-cent increase, the Commission made no attempt whatsoever to explain the basis for it. In fact, that item is not even described in the Commission Opinion. The only reference to it in any manner whatsoever in the Opinion appears in the following statement:

> "Based on the evidence in this proceeding and for the reasons set forth in the preceding paragraphs, we find that the rate of 22.375 cents per Mcf proposed in the settlement is the just and reasonable rate subject to the automatic and contingent escalations as provided herein to be applied to all future deliveries of gas under contracts dated prior to October 1, 1968." (2 A 648)

The term "automatic . . . escalations as provided herein" is the only reference to this half-cent increase in the Opinion. The "evidence" and "reasons" referred to in the Commission's statement contain no reference whatsoever to that half-cent increase.

That half-cent increase, applied to the 80 TCF of proved reserves in Southern Louisiana as of 1969,[16] will, by itself, increase their value by $400,000,000 and it will increase annual revenues on the approximately 6.8 TCF of Production [17] by $34,000,000.

Yet the entire opinion contains not one word about any need for it, cost-wise or otherwise. There are no findings which discuss its effect on gas supplies, or even indicate that it will have an effect upon them. There is no consideration of its fairness to the consumer. There are no findings of any benefits to be received from it by the purchasers. It requires a very close reading of the Opinion to find a reference to the provision at all.

Obviously, it is there because the settlement negotiations put it there, and for no other reason. That is not enough.

As to the three half-cent contingent increases, the Commission at least brought them to the light of day and described them. (2 A 649) There is no discussion and no evidence and no finding to support the need for them, or to provide any assurance that they will provide any more new reserves than the producers would have dedicated without them. For the five year period 1965-1969 the annual "new supply additions" in South Louisiana, reflected in the pipeline's Form 15 annual reports, averaged about 4.3 TCF. (5 A 115e, Ex. 21, Sch. 2) Thus, the producers need do no more than they have been doing—at much lower new-gas rates—in

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[16] 5 A 93e, Ex. 21, Sch. 34.

[17] 5 A 93e, Ex. 21, Sch. 34.

order to achieve the first plateau and the first half-cent in about two years.

The second and third plateaus are even easier to reach, each requiring only 3.75 TCF of new reserves. Before giving away this much of the consumer's dollars, the Commission should at least have made a finding that these new reserves probably would not be obtained without this added bonus. But the Commission could make no such finding, because it would be absurd on its face.

Under the terms of the settlement provision, the producers have nearly seven years to reach the total 15 TCF. This would require annual additions even lower than the "new supply additions" for 1965-1969. (5 A 115e, Ex. 31, Sch. 2)

Surely, a step which imposes upon consumers additional rates of the order of magnitude of $1,000,000,000[18] over the life of the present reserves requires some consideration on the record and some finding of need for it and probable benefits from it. These findings are conspicuous by their absence.[19]

But there are two other fallacies about these half-cent increases, obvious on the face of them, which make them unreasonable and discriminatory *per se,* absent any explanation:

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[18] The total increase of 2 cents, applied to the 80 TCF of proved reserves, would produce $1,600,000,000, but the increases will not all go into effect at once.

[19] There is no indication, nor even a suggestion, that the costs associated with flowing gas will increase appreciably. The finding and drilling costs are already paid, and only the costs of production remain. Furthermore, as the Fifth Circuit observed in *Austral,* 428 F.2d at 430, the Commission found that "costs as a whole during this decade (the 1960's) had been remarkably stable (or were even declining slightly) and were likely to remain so, and this finding is based upon substantial evidence."

(1) The benefits are limited solely to producers who have production already in Louisiana. New entrants get no part of these increases. The old Louisiana hands are rewarded doubly for any new reserves—they receive a rate of 26 cents, plus an eventual subsidy of 2 cents per Mcf from their old gas. The new entrant cannot compete on equal terms.

(2) To add insult to the injury of the consumers and the new producer entrant, his exploratory efforts will go toward making up the various plateaus which will put more money in the pockets of his competitors. The old Louisiana producer need do nothing whatsoever to be entitled to the three contingent increases. If he never drills another well, he can still enjoy the increases as they apply to his already flowing gas reserves. He benefits from his competitors' efforts.

Even without the obvious exclusionary aspects of the four increases, vis-a-vis new producer entrants into the Louisiana market, the patent unfairness of this provision cries out for reversal.

Again there is demonstrated the danger of regulation by negotiation. At the bargaining table, the large producer corporations, dealing with a product which produced only 5 percent of their revenues, held life-or-death economic power over the pipelines and distributors, who were desperate for gas. Furthermore, the pipelines (who have yet to contest a general producer increase) knew that they would have no problem passing along their increases to their customers. And the distributors, for the most part, were in the same situation as to their customers. The reason these negotiators were willing to accept absurdities in the settlement is that they were, by and large, negotiating with other people's money. The Commission disclaimed a what-the-traffic-will-bear approach (2 A 628) but that

is the inevitable result of regulation by negotiation where consumer advocates have no leverage. It is precisely to avoid putting the consumer in that position that the Federal Power Commission exists.

The Court of Appeals again recognized the discrimination resulting from this provision. The producer with small refund obligations, and the new producer-entrant into the area, both contribute to the new reserves, and their competitors with existing reserves and refund commitments reap the benefits. The Court of Appeals had no answer to this except to say that "half a loaf is better than no loaf at all" and that "an administrative choice is not to be rejected because one party may get icing on his cake while another only gets cake." (App. C to Pet. 50)

The Court of Appeals for the District of Columbia dealt with very similar contingent escalation provisions at length in its *Texas Gulf Coast* Opinion at 387 F.2d 1068, 1077. It pointed out:

> that the Natural Gas Act does not permit a result "in which the mere need for supply automatically justifies any and all proposals, or demands, by the person able to provide the needed supply." 487 F.2d 1071;
>
> that "it is hard to discern what reason could justify an agency acting in such a way as to provide incentives without a glimmer of their extent." (Id. at 1072)
>
> and that there is no meaningful relationship of benefits to burdens in the escalation provision (Id. at 1072);
>
> that investment outlays depend upon evaluation of future profits, and not upon past or recent receipts from activities begun in the past (Id. at 1073);

that the Commission's "explanation" of its price escalation provisions "is not an explanation but a conclusion. . . . No semblance of analysis is indicated, in terms of the consequences upon industry structure from the provisions, nor is any reasoned consideration given to the alternative of an increase in the new gas price." (Id. at 1074);

that "the pragmatic need for room and time to experiment cannot substitute for reasoned analysis when the rate structure raises a serious problem of discrimination, a result which the statute expressly guards against, and which the Commission has long had experience in enforcing." (Id. at 1075);

that the question of discrimination cannot be dealt with merely on the basis that "one producer's piece of cake is iced and another's is not" because "at stake is the consumer's interest in effective competitive conditions in the industry." (Id. at 1076)

CONCLUSION

This Court has said in the *Permian Basin Area Rate Cases,* 390 U.S. 747, 791-2, that the issues on review of a case like this are

> Did the Commission's order abuse or exceed its authority?
>
> Are each of the order's essential elements supported by substantial evidence?
>
> Does the order, while adequately compensating the producer, yet provide appropriate protection to the relevant public interests?

The Commission Order herein fails on all three counts:

> The Commission exceeded its authority in remaking past rates and granting reparations in the form of reduced or eliminated refunds; and it abused its discretion by adopting a discriminatory method of refund work-off.

> The basic elements of the Commission's order relative to refunds are totally unsupported by evidence; and its adoption of future escalations for flowing gas rates is equally unsupported.
>
> There is no protection for the relevant public interests, because the Commission has made no attempt to balance burdens with benefits, or to see that those who are charged with non-cost "incentive" additives are repaid in any way.

The Commission has adopted uncritically an industry settlement, arrived at by negotiations between producers who controlled virtually the entire supply of gas, and pipelines and distributors who were desperate for gas. A more unequal bargaining position can hardly be conceived. But, in addition, the pipelines and distributors were negotiating over refunds which they could not keep, and over rate increases which they could easily pass along to the consumer. Small wonder the consumer's interests received scant protection.

The Court of Appeals felt that the gas shortage so filled horizon that all else was secondary, and review should be done with "kid gloves." But the Court of Appeals of the District of Columbia summed it up well when it said

> "We fail to discern a difference between a 'kid glove' and a 'rubber stamp' if all that is needed as a reason for Commission action is to point to a supply shortage." 487 F.2d at 1080.

The danger inherent in that kind of judicial approach is that "unless we make the requirements for administrative action strict and demanding, *expertise,* the strength of modern government, can become a monster which rules with no practical limits on its discretion."

Burlington Truck Lines v. *United States,* 371 U.S. 156, 167.

WHEREFORE, petitioners respectfully pray:

1. That the Opinion of the Court of Appeals and Opinion and Order No. 598 of the Commission be reversed insofar as said Order modifies, reduces or interferes with the refunds provided for in the Commission's Order No. 546, and that this cause be remanded to the Commission for such further proceedings as may be necessary for the computation and payment of said refunds as provided for in Opinion and Order No. 546, together with appropriate interest thereupon;

2. That the Opinion of the Court of Appeals be reversed insofar as it affirms that portion of Opinion No. 598 of the Commission which provides for automatic or conditional increases in rates for flowing gas committed to contract prior to the Commission's cut-off date of October 1, 1968.

Respectfully submitted,

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